Pharmaceutical scam

Use audit to detect 'Pyramid Cube Scheme'

by Jerome Richard Gardner

EVERY HOSPITAL PURCHASING AGENT, buyer and material manager should be continually searching for and trying to obtain the best product at the best price.

Volume is one of the most common influential predictors of price. It is the key factor that contributes the most to the reduction of the price of a product. If a hospital has adequate short-term storage facilities and high turnover, it can order large quantities of goods and obtain volume discounts inherent in standardized volume procurement. Increased volume also establishes a greater usage base for future contract negotiations of price and represents a greater commission level for salespersons.

Volume purchase incentives have also been expressed clearly and reinforced by the government in the "prudent buyer principle" in Section 2103 of the *Medicare Provider Reimbursement Manual.* It says:

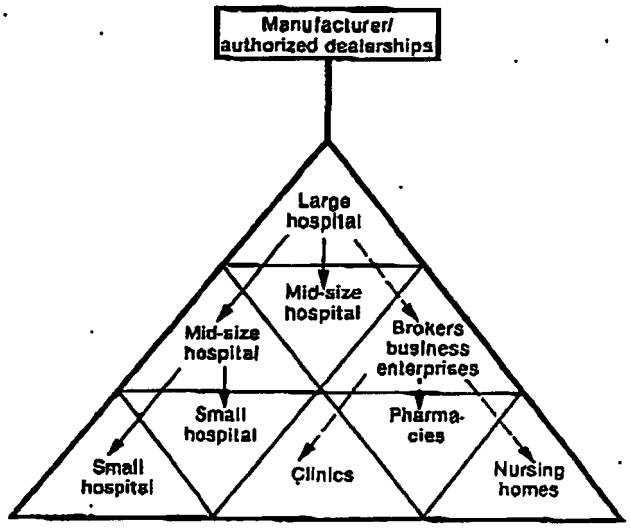
> The prudent and cost-conscious buyer not only refuses to pay more than the going price for an item or service, he also seeks to economize by minimizing cost. This is especially so when the buyer as an institution or organization which makes bulk purchases can, therefore, often gain discounts because of the size of its purchases. It is quite common that discounts are given in these instances. In addition, bulk purchase of items or services often give leverage in bargaining with suppliers for other items or services. Any alert and cost-conscious buyer seeks such advantages, and it is expected that Medicare providers of services will also seek them.

Shared services agreements

Since the early 1900's tax-exempt hospitals have organized and participated in shared purchasing arrangements (shared services agreements). These arrangements were formed to obtain preferential prices for one's "own use" in compliance with the law. By combining their purchasing efforts, hospitals were able to increase their volume/usage base, and thereby strengthen their position in negotiating lower prices.

Continued on page 74

Exhibit 1: Comparison of shared services agreement with 'the Pyramid Cube Scheme'



Shared services agreement	*Pyramid cube scheme*
• Legal — for one's "own use"	• Illegal —501(c)(3) status jeopardy —Offset Medicare reimbursement problems —Violation of antitrust laws
• Preferential prices	• Discrimination in price (violation of U.S. Code Statutes)
• Cost containment for hospital	• Profits to middleman —No warehousing costs —No insurance/handling costs —No inventory —No investment (cash outlay)

The term *"Pyramid Cube Scheme"* denotes the reselling ripple effect from large institutions (lowest cost/direct access) to local satellite clinics, small drugstores, and nursing homes.

EXHIBIT

tabbies

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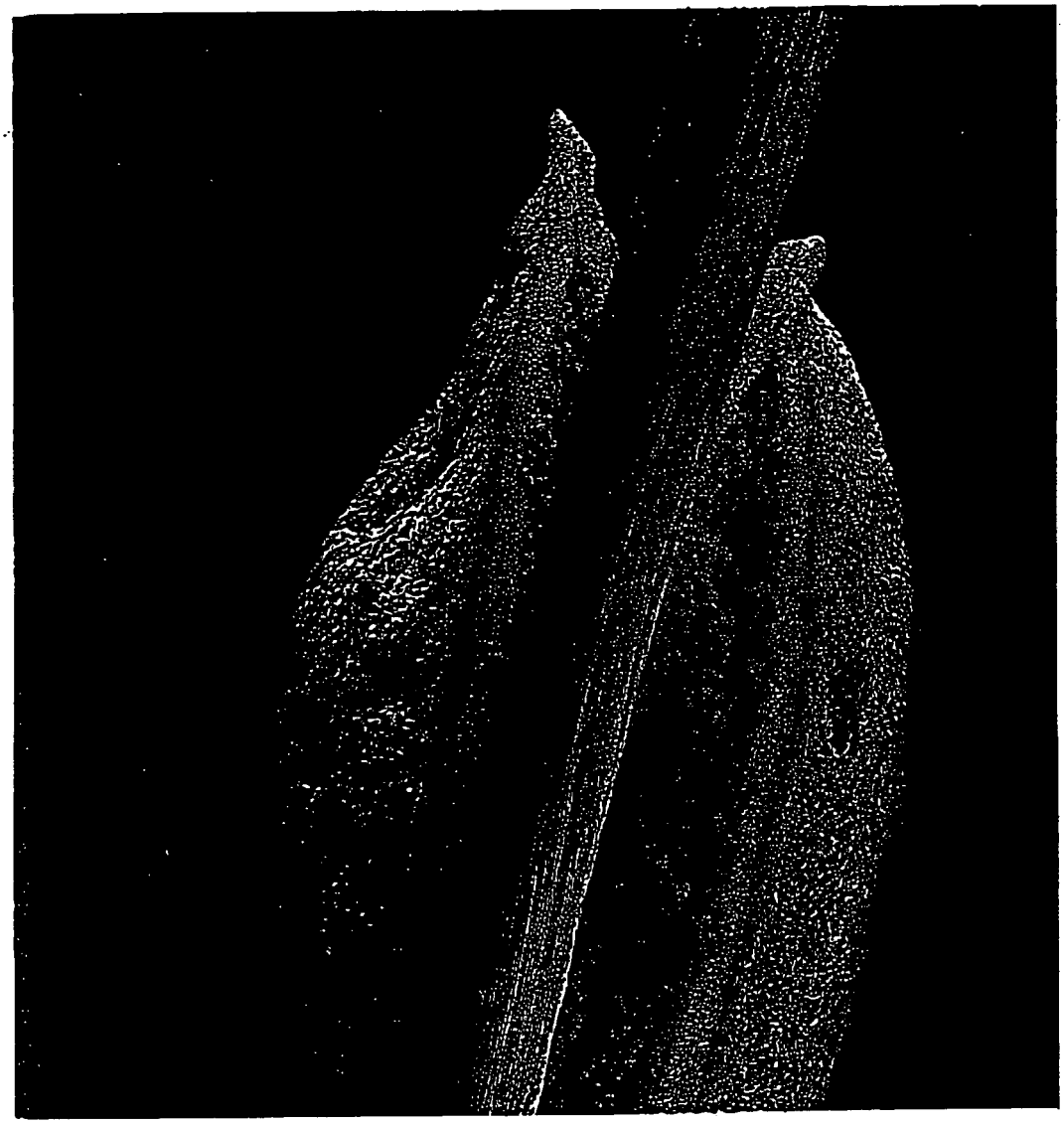

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Pyramid Cube Scheme

From page 72

Pyramid cube scheme

It appears that a new and questionable approach to cost containment for pharmaceutical purchases has arrived, which for the purposes of this article will be called the "Pyramid Cube Scheme." (See Exhibit 1) Today, hospital purchasing personnel are being approached by questionable brokers/business enterprises who try to convince them to over-order pharmaceuticals for the purpose of reselling the excess pharmaceuticals to them for a profit, thereby reducing the hospital's costs.

The pharmaceutical products selected by the brokers are normally only sold direct or via authorized dealerships to the hospital intended for its own use and not for resale purposes.

The excess pharmaceuticals, warehoused in the hospital, are then resold and delivered by the brokers to local satellite clinics and small drugstores at a profit to the hospital and the brokers. Although a profit margin is incorporated in the price, the small institutions/businesses are now able to purchase the goods at a lower cost than they would normally pay to the manufacturer or dealerships. The greater the volume ordered by the hospital, the lower the obtainable bid price—the greater the margin for profit.

Legal aspects and ramifications

Although the hospital is reducing the cost of its pharmaceutical goods, the possible disadvantages to the hospital are often overlooked or ignored by the parties involved. There are several legal aspects that should be considered. They include:

- Improper recording of transactions. Accounting for profits in the hospital records, financial balance sheet presentations and sales tax applications.
- Effects on an institution's tax-exempt (501) (c) (3) organizational status.
- Problem in properly offsetting Medicare reimbursement. This creates a thin line between the felony of Medicare-Medicaid fraud abuse and the practice of selling drugs to the retail market.
- Violation of U.S. Code Statutes. The statutes make it unlawful for a buyer to knowingly induce or receive a discrimination in price.
- Legal suit. To resell goods without the expressed approval of the manufacturer.
- Violation of antitrust laws for misuse of "preferential prices" allowed by the 1938 Non-Profit Institutions Act (Public Law 75-650-15 U.S.C. 13c). The purchase and purpose of supplies for one's "own use" was defined for hospitals by the Supreme Court in Abbott Laboratories et al v. Portland Retail Druggist Association, Inc. (1975) as:
  —Inpatients, emergency facility patients and outpatients for the personal use of the patients in treatment or consultation on the hospital's premises;
  —Inpatients, emergency facility patients and outpatients for the personal use of the patients for a limited and reasonable time away from the premises as a continuation of or supplement to the treatment at the hospital's premises (but not refills of former patients' prescriptions);
  —Employees, members of physician staff, students working at the hospital and similar persons who are rendering services in connection with the hospital's activities—for their own use and the use of their dependents; and
  —Occasional "walk-in" buyers in particular emergency situations where no other pharmacy is available.

Other ramification

- Costs of warehousing. Cash flow effects.
- Security problems. Keeping non-employees out of storeroom areas.
- Potential for the mishandling of funds (kickbacks).

This article is intended to encourage hospitals to double check their internal procedures to ascertain if this practice is occurring. It can be checked using the audit process.

Audit checks to consider:

- Verify that appropriate accounting entries are made to reflect the responsibility for asset custody.
  —Scrutinize credits applied to pharmacy inventory, expense accounts.
  —Examine the origin of non-operating or other operating revenue account entries.
- Verify accounts payable records.
  —Review purchase orders, invoices, receiving reports to ascertain proper/authorized execution. Inspect orders for high-lighted segregation notations, lack of documentation, address changes, or shipments to a location other than the hospital.
- Verify that appropriate segregation of functional responsibilities are adequate for provisions for independent verification.
  —Analyze organizational chart, work flow in departments, job descriptions, and the quality of personnel hiring practices.

These tactical measures provide assurance that transactions are properly authorized and accurately recorded.

Remember the appropriate and careful control scrutinization of pharmacy inventory is very important to both the provider and recipient of hospital services. Through proper and acceptable measures hospitals can control and maintain their pharmacy inventories at levels that will insure adequate stock to meet the needs of their patients and at the same time minimize their costs.

A shared purchasing agreement, used legally to obtain preferential prices for goods for one's "own use," is an acceptable approach to cost containment. The "Pyramid Cube Scheme," used as an illegal profit for others, should be discouraged, especially for all tax-exempt hospitals. □